

Porters 5 Forces

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1 Introduction

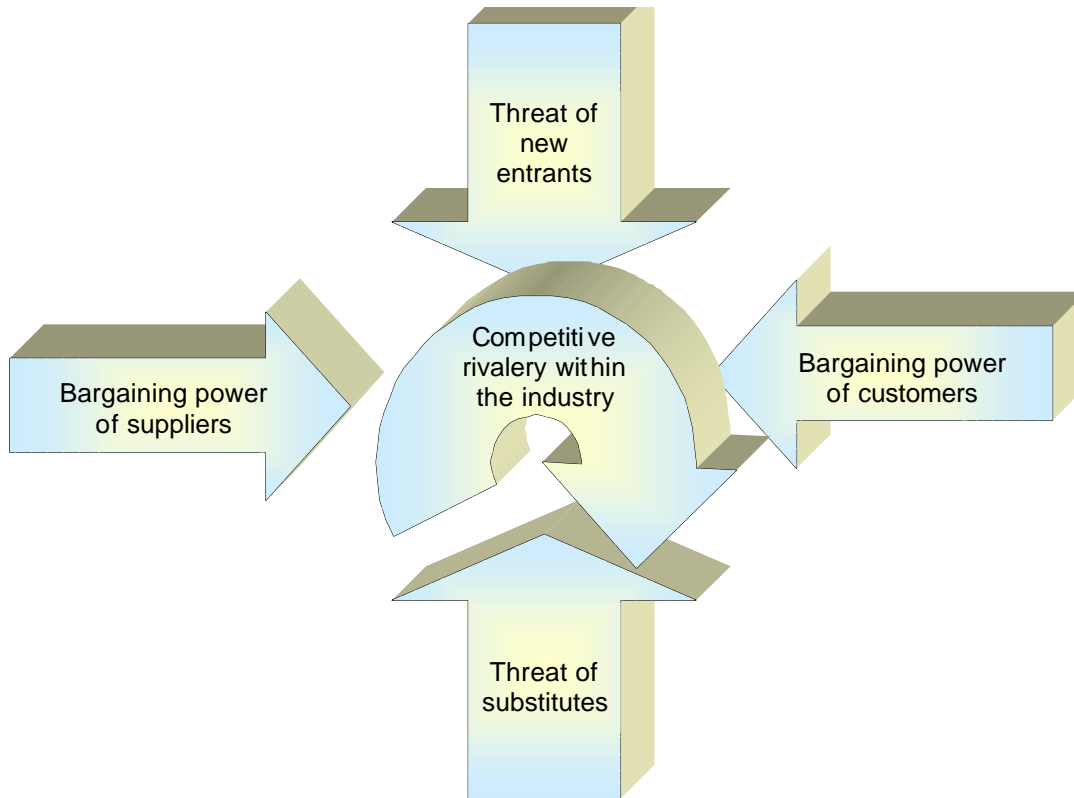
The model of the Five Competitive Forces was developed by Michael E. Porter in his book „Competitive Strategy: Techniques for Analyzing Industries and Competitors“ in 1980. Since that time it has become an important tool for analyzing an organizations industry structure in strategic processes.

Porters model is based on the insight that a corporate strategy should meet the opportunities and threats in the organizations external environment. Especially, competitive strategy should base on and understanding of industry structures and the way they change. Porter has identified five competitive forces that shape every industry and every market. These forces determine the intensity of competition and hence the profitability and attractiveness of an industry. The objective of corporate strategy should be to modify these

competitive forces in a way that improves the position of the organization. Porters model supports analysis of the driving forces in an industry. Based on the information derived from the Five Forces Analysis, management can decide how to influence or to exploit particular characteristics of their industry.

2 The Five Competitive Forces

The Five Competitive Forces are typically described as follows:



2.1 Bargaining Power of Suppliers

The term 'suppliers' comprises all sources for inputs that are needed in order to provide goods or services.

Supplier bargaining power is likely to be high when:

- The market is dominated by a few large suppliers rather than a fragmented source of supply,
- There are no substitutes for the particular input,
- The suppliers customers are fragmented, so their bargaining power is low,
- The switching costs from one supplier to another are high,
- There is the possibility of the supplier integrating forwards in order to obtain higher prices and margins. This threat is especially high when
 - The buying industry has a higher profitability than the supplying industry,
 - Forward integration provides economies of scale for the supplier,

- The buying industry hinders the supplying industry in their development (e.g. reluctance to accept new releases of products),
- The buying industry has low barriers to entry.

In such situations, the buying industry often faces a high pressure on margins from their suppliers. The relationship to powerful suppliers can potentially reduce strategic options for the organization.

2.2 Bargaining Power of Customers

Similarly, the bargaining power of customers determines how much customers can impose pressure on margins and volumes.

Customers bargaining power is likely to be high when

- They buy large volumes, there is a concentration of buyers,
- The supplying industry comprises a large number of small operators
- The supplying industry operates with high fixed costs,

- The product is undifferentiated and can be replaced by substitutes,
- Switching to an alternative product is relatively simple and is not related to high costs,
- Customers have low margins and are price-sensitive,
- Customers could produce the product themselves,
- The product is not of strategic importance for the customer,
- The customer knows about the production costs of the product
- There is the possibility for the customer integrating backwards.

2.3 Threat of New Entrants

The competition in an industry will be the higher, the easier it is for other companies to enter this industry. In such a situation, new entrants could change major determinants of the market environment (e.g. market shares, prices, customer loyalty) at any time. There is always a latent pressure for reaction and adjustment for existing players in this industry. The threat of new entries will depend on the extent to which there are barriers to entry. These are typically

- Economies of scale (minimum size requirements for profitable operations),
- High initial investments and fixed costs,
- Cost advantages of existing players due to experience curve effects of operation with fully depreciated assets,
- Brand loyalty of customers
- Protected intellectual property like patents, licenses etc,
- Scarcity of important resources, e.g. qualified expert staff
- Access to raw materials is controlled by existing players,
- Distribution channels are controlled by existing players,
- Existing players have close customer relations, e.g. from long-term service contracts,

- High switching costs for customers
- Legislation and government action

2.4 Threat of Substitutes

A threat from substitutes exists if there are alternative products with lower prices of better performance parameters for the same purpose. They could potentially attract a significant proportion of market volume and hence reduce the potential sales volume for existing players. This category also relates to complementary products.

Similarly to the threat of new entrants, the threat of substitutes is determined by factors like

- Brand loyalty of customers,
- Close customer relationships,
- Switching costs for customers,
- The relative price for performance of substitutes,
- Current trends.

2.5 Competitive Rivalry between Existing Players

This force describes the intensity of competition between existing players (companies) in an industry. High competitive pressure results in pressure on prices, margins, and hence, on profitability for every single company in the industry.

Competition between existing players is likely to be high when

- There are many players of about the same size,
- Players have similar strategies
- There is not much differentiation between players and their products, hence, there is much price competition
- Low market growth rates (growth of a particular company is possible only at the expense of a competitor),
- Barriers for exit are high (e.g. expensive and highly specialized equipment).

3 Use of the Information from Five Forces Analysis

Five Forces Analysis can provide valuable information for three aspects of corporate planning:

Statical Analysis:

The Five Forces Analysis allows determining the attractiveness of an industry. It provides insights on profitability. Thus, it supports decisions about entry to or exit from and industry or a market segment. Moreover, the model can be used to compare the impact of competitive forces on the own organization with their impact on competitors. Competitors may have different options to react to changes in competitive forces from their different resources and competences. This may influence the structure of the whole industry.

Dynamical Analysis:

In combination with a PEST-Analysis, which reveals drivers for change in an industry, Five Forces Analysis can reveal insights about the potential future attractiveness of the industry. Expected political, economical, socio-demographical and technological changes can influence the five competitive forces and thus have impact on industry structures. Useful tools to determine potential changes of competitive forces are scenarios.

Analysis of Options:

With the knowledge about intensity and power of competitive forces, organizations can develop options to influence them in a way that improves their own competitive position. The result could be a new strategic direction, e.g. a new positioning, differentiation for competitive products or strategic partnerships (see section 4).

Thus, Porters model of Five Competitive Forces allows a systematic and structured analysis of market structure and competitive situation. The model can be applied to particular companies, market segments, industries or regions. Therefore, it is necessary to determine the scope of the market to be analyzed in a first step. Following, all relevant forces for this market are identified and analyzed. Hence, it is not necessary to analyze all elements of all competitive forces with the same depth.

The Five Forces Model is based on microeconomics. It takes into account supply and demand, complementary products and substitutes, the relationship between volume of production and cost of production, and market structures like monopoly, oligopoly or perfect competition.

4 Influencing the Power of Five Forces

After the analysis of current and potential future state of the five competitive forces, managers can search for options to influence these forces in their organization's interest. Although industry-specific business models will limit options, the own strategy can change the impact of competitive forces on the organization. The objective is to reduce the power of competitive forces.

The following figure provides some examples. They are of general nature. Hence, they have to be adjusted to each organization's specific situation. The options of an organization are determined not only by the external market environment, but also by its own internal resources, competences and objectives.

<p>4.1 Reducing the Bargaining Power of Suppliers</p>	<p>4.2 Reducing the Bargaining Power of Customers</p>
<ul style="list-style-type: none"> • Partnering • Supply chain management • Supply chain training • Increase dependency • Build knowledge of supplier costs and methods • Take over a supplier 	<ul style="list-style-type: none"> • Partnering • Supply chain management • Increase loyalty • Increase incentives and value added • Move purchase decision away from price • Cut put powerful intermediaries (go directly to customer)
<p>4.3 Reducing the Treat of New Entrants</p>	<p>4.4 Reducing the Threat of Substitutes</p>
<ul style="list-style-type: none"> • Increase minimum efficient scales of operations • Create a marketing / brand image (loyalty as a barrier) • Patents, protection of intellectual property • Alliances with linked products / services • Tie up with suppliers • Tie up with distributors • Retaliation tactics 	<ul style="list-style-type: none"> • Legal actions • Increase switching costs • Alliances • Customer surveys to learn about their preferences • Enter substitute market and influence from within • Accentuate differences (real or perceived)
<p>4.5 Reducing the Competitive Rivalry between Existing Players</p>	
<ul style="list-style-type: none"> • Avoid price competition • Differentiate your product • Buy out competition • Reduce industry over-capacity • Focus on different segments • Communicate with competitors 	

5 Critique

Porter's model of Five Competitive Forces has been subject of much critique. Its main weakness results from the historical context in which it was developed. In the early eighties, cyclical growth characterized the global economy. Thus, primary corporate objectives consisted of profitability and survival. A major prerequisite for achieving these objectives has been optimization of strategy in relation to the external environment. At that time, development in most industries has been fairly stable and predictable, compared with today's dynamics.

In general, the meaningfulness of this model is reduced by the following factors:

- In the economic sense, the model assumes a classic perfect market. The more an industry is regulated, the less meaningful insights the model can deliver.
- The model is best applicable for analysis of simple market structures. A comprehensive description and analysis of all five forces gets very difficult in complex industries with multiple interrelations, product groups, by-products and segments. A too narrow focus on particular segments of such industries, however, bears the risk of missing important elements.
- The model assumes relatively static market structures. This is hardly the case in today's dynamic markets. Technological breakthroughs and dynamic market

entrants from start-ups or other industries may completely change business models, entry barriers and relationships along the supply chain within short times. The Five Forces model may have some use for later analysis of the new situation; but it will hardly provide much meaningful advice for preventive actions.

- The model is based on the idea of competition. It assumes that companies try to achieve competitive advantages over other players in the markets as well as over suppliers or customers. With this focus, it does not really take into consideration strategies like strategic alliances, electronic linking of information systems of all companies along a value chain, virtual enterprise-networks or others.

Overall, Porters Five Forces Model has some major limitations in today's market environment. It is not able to take into account new business models and the dynamics of markets. The value of Porters model is more that it enables managers to think about the current situation of their industry in a structured, easy-to-understand way – as a starting point for further analysis.